No. 06-43

In The Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

BRIEF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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TABLE OF CONTENTS

Page

TABLE OF CONTENTS i

TABLE OF AUTHORITIES iii

INTEREST OF THE *AMICUS CURIAE* 1

SUMMARY OF THE ARGUMENT 2

ARGUMENT 5

I. PETITIONER'S PROPOSED "PURPOSE AND EFFECT" STANDARD FOR IMPOSING SCHEME LIABILITY IGNORES THE CLEAR LANGUAGE OF SECTION 10(b) AND WOULD CONSTITUTE A DRAMATIC DEPARTURE FROM ESTABLISHED PRECEDENT 5

A. Any Claim Asserted Under Section 10(b) Or Rule 10b-5 Must Satisfy The "Use Or Employ" And "In Connection With" Requirements 5

B. The "In Connection With" Requirement Is Satisfied Only If A Defendant's Fraudulent Actions Necessarily Required Or Depended Upon A Securities Transaction 6

C. A Defendant "Uses" Or "Employs" A Deceptive Device Only If It Directs A Specific And Affirmative Deceptive Act Toward Investors 10

D. Petitioner Ignores Section 10(b)'s "Use Or Employ" And "In Connection With" Requirements, As Does Petitioner's Proposed "Purpose And Effect" Test 12

E. Section 10(b) Liability Requires A Breach Of A Duty To Plaintiffs 15

TABLE OF CONTENTS – Continued

Page

II. PETITIONER'S PROPOSED "PURPOSE AND EFFECT" TEST IS CONTRARY TO SOUND PUBLIC POLICY 17

A. The Uncertainty Generated By Petitioner's "Purpose And Effect" Test Would Chill Legitimate Commerce And Harm The Economy As A Whole 17

B. Petitioner's "Purpose And Effect" Test Would Encourage Frivolous Claims, Increase Defendants' Cost Of Litigating And Encourage Coercive Settlements..... 22

C. Section 10(b) Jurisprudence Should Not Be Premised Upon A Search For Deep Pockets..... 28

CONCLUSION..... 30

TABLE OF AUTHORITIES

Page

CASES

Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972) 9, 15

Bailey v. United States, 516 U.S. 137 (1995) 11

Basic, Inc. v. Levinson, 485 U.S. 224 (1988) 16

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 17, 18, 24, 26

Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994) ..... *passim*

Chiarella v. United States, 445 U.S. 222 (1980) 13, 15, 16

Dirks v. S.E.C., 463 U.S. 646 (1983) 16

Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005) 26, 28

Dutton v. D & K Healthcare Res., No. 4:04CV147SNL, 2006 WL 1778863 (E.D. Mo. June 23, 2006) 12, 19

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 5

Feldman v. Pioneer Petroleum, Inc., 813 F.2d 296 (10th Cir. 1987) 14

In re Charter Commc'ns, Inc. Sec. Litig., 443 F.3d 987 (8th Cir. 2006) 15, 29

In re Dynegy, Inc. Sec. Litig., 339 F. Supp. 2d 804 (S.D. Tex. 2004) 19

In re Enron Corp., No. MDL-1446, Civ. Action No. H-01-3624, 2006 WL 4381143 (S.D. Tex. June 5, 2006) 19

TABLE OF AUTHORITIES – Continued

Page

In re Homestore.com, Inc. Sec. Litig., 252 F. Supp. 2d 1018 (C.D. Cal. 2003) 19

In re Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161 (D. Mass. 2003) 19, 22

In re Parmalat Sec. Litig., 376 F. Supp. 2d 472 (S.D.N.Y. 2005) 19, 22

Jones v. United States, 529 U.S. 848 (2000) 11

Marine Bank v. Weaver, 455 U.S. 551 (1982) 14

McBoyle v. United States, 283 U.S. 25 (1931) 17

McGann v. Ernst & Young, 102 F.3d 390 (9th Cir. 1996) 10

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503 (2006) 17, 27

Pinter v. Dahl, 486 U.S. 622 (1988) 17, 18

Piper v. Chris-Craft Industries, Inc., 430 U.S. 1 (1977) 7

Quaak v. Dexia, 357 F. Supp. 2d 330 (D. Mass. 2005) 19, 23

Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372 (5th Cir. 2007) 23

S.E.C. v. Zandford, 535 U.S. 813 (2002) 6, 7, 9, 13

Santa Fe Indus. v. Green, 430 U.S. 462 (1977) 15

Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (2006) 12

Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971) 6, 7, 8

TABLE OF AUTHORITIES – Continued

Page

Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499 (2007) 24, 26

The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588 (2001) 7, 8

United States v. Cyprian, 197 F.3d 736 (5th Cir. 1999) 11

United States v. O'Hagan, 521 U.S. 642 (1997) 5, 7, 9, 16

Wilson v. Garcia, 471 U.S. 261 (1985) 17

STATUTES

15 U.S.C. § 78j (2007) ..... *passim*

15 U.S.C. § 78t(e) (2007) 27

15 U.S.C. § 78u-4(b) (2007) 27

15 U.S.C. § 78u-4(f)(2)(A) (2007) 25

Private Securities Litigation Reform Act of 1995, Pub. L. 104-69, 109 Stat. 737 (Dec. 22, 1995) 27

Securities Litigation Uniform Standards Act of 1998, Pub. L. 105-353, 112 Stat. 3227 (Nov. 3, 1998) 27

OTHER AUTHORITIES

Andrew S. Gold, *Reassessing the Scope of Conduct Prohibited by Section 10(b) and the Elements of Rule 10b-5: Reflections on Securities Fraud and Secondary Actors*, 53 Cath. U. L. Rev. 667 (Spring 2004) 11

H.R. Rep. No. 104-369 (1995) 27

TABLE OF AUTHORITIES – Continued

Page

Remarks of Sen. Sanford, 138 Cong. Rec. S12605 (Aug. 12, 1992) 24

Statement of J. Carter Beese, Jr., Chairman on behalf of the Capital Markets Regulatory Reform Project, Center for Strategic and International Studies before the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, 1995 WL 83860 (March 2, 1995) 22

Testimony of Michael Morris, Vice President and General Counsel of Sun Microsystems before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, 1998 WL 96483 (F.D.C.H.) (Feb. 23, 1998) 25

Webster's New International Dictionary (2d ed. 1934) 10

INTEREST OF THE *AMICUS CURIAE*[1]

The National Association of Manufacturers (the "NAM") is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards. In support of this mission, the NAM regularly files briefs *amicus curiae* in this Court and other courts.

The NAM does not condone securities law violations or deceptive conduct in any form or for any purpose. Nevertheless, the NAM opposes the position of Petitioner in this case. The expansive and nebulous theory of scheme liability advocated by Petitioner in this case lacks any basis in the statutory text or the Court's precedent and threatens to ensnare law-abiding manufacturers in the costly web of securities class action litigation based on the conduct of those with whom they do business. Were the Court to adopt such a theory, American manufacturers would be exposed to a greatly increased risk of frivolous securities fraud litigation. Legitimate commerce would be chilled both by the uncertainty inherent in Petitioner's proposed standard and by the heavy cost of defending against frivolous securities litigation claims, undercutting the competitiveness of the U.S. economy. American manufacturers can succeed only if the rules governing their

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[1] This *amicus* brief is filed with all parties' consent. No counsel for any party authored this brief in whole or in part, and no person or entity other than *amicus*, its members and its counsel made a monetary contribution to the preparation or submission of this brief.

potential liability are clear, as they have been under this Court's jurisprudence for the past several decades. The NAM seeks to preserve this clarity for its members.

SUMMARY OF THE ARGUMENT

Petitioner urges this Court to dramatically expand the private right of action under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"). Under Petitioner's proposed "purpose and effect" test, anyone allegedly participating in a "scheme to defraud" investors can be held liable under Section 10(b), regardless of whether that actor had any contact with those investors or owed them any duty. In arguing that the conduct of such actors is encompassed by Section 10(b), Petitioner ignores the language of the statute that explicitly limits its reach. Petitioner also ignores this Court's precedent, including *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), which prohibited private rights of action against peripheral actors for the type of aiding and abetting conduct that Petitioner now seeks to capture under the rubric of "scheme liability."

The broad expansion of actors subject to primary liability under Section 10(b) that Petitioner seeks is inconsistent with the statute's requirement that liability be based on the use or employment of a deceptive device that occurs "in connection with the purchase or sale of any security." The "in connection with" requirement, as repeatedly construed by this Court, limits the reach of private civil actions under Section 10(b) to defendants whose conduct necessarily requires or is dependent upon a securities transaction. Thus, only those parties that make a disclosure to investors, owe investors a specific fiduciary duty or engage in insider trading can satisfy the "in connection with" requirement. By contrast, those parties

who engage in commercial transactions with an issuer of securities, such as the sale of goods and services, have not acted in connection with a purchase or sale of securities. They make no disclosures to their purchasers' shareholders, owe them no fiduciary duty, and do not engage in insider trading. Under these circumstances, manufacturers should not be subject to liability under Section 10(b). Nevertheless, Petitioner's "purpose and effect" test seeks to impose such liability on this broad category of companies and individuals.

Petitioner's "purpose and effect" test also ignores Section 10(b)'s requirement that a defendant "use or employ" a deceptive device in connection with a purchase or sale of securities. This requirement limits Section 10(b) liability to persons or entities who take an affirmative action that deceives investors. In this case, and in numerous other cases alleging "scheme liability," the vendor or purchaser of goods did not interact with the issuer's investors at all and, thus, did not "use or employ" a deceptive device against them. Allegations that a third party assisted a public company that itself used or employed a deceptive device against its own shareholders do not give rise to primary liability against the third party. Instead, the third party may be held liable only for aiding and abetting in a claim brought against it by the SEC.

Petitioner also ignores the well-established principle that an actor cannot be liable for a Section 10(b) violation unless it breaches a duty to investors. Such a duty can be based on an existing fiduciary relationship between an actor and investors or can arise by virtue of a statement that the actor makes to investors. Here, as in many scheme liability cases, Petitioner does not allege either that Respondents made any misstatement to Charter's shareholders or that they owed them any other duty. Alleging that Respondents

acted as part of a "scheme" is insufficient to subject them to Section 10(b) liability without the requisite duty.

Petitioner's broad scheme liability theory is not only contrary to precedent but it also is at odds with sound public policy. The "purpose and effect" test proposed by Petitioner would lead to great uncertainty among manufacturers and others who do business with issuers of securities concerning their potential securities fraud liability. This ambiguity in an area of the law with enormous potential liability contravenes the well-established goal of this Court to promote certainty and predictability.

Moreover, were the Court to adopt the "purpose and effect" test, plaintiffs would invariably barrage manufacturers and sellers of products with securities fraud lawsuits every time they engaged in commerce with a public company that improperly accounted for, or failed to correctly describe, a transaction with them. The vagueness inherent in the "purpose and effect" test would make it difficult, if not impossible, for such third parties to obtain dismissal of these claims under Rule 12(b)(6). Therefore, third party manufacturers and sellers would be forced to expend considerable sums defending themselves in securities litigations where they neither made any statements nor owed any duties to the investor class. The heavy costs involved in defending these suits would allow plaintiffs to coerce settlements. Additionally, the elevated risk of incurring such costs and the potential imposition of securities fraud liability would significantly increase the costs of doing business for America's manufacturers, vendors and providers of goods and services. Such an outcome would make American companies less competitive, harm the domestic economy and discourage foreign companies from doing business with domestic companies, resulting in higher prices and fewer choices for American consumers.

In sum, Petitioner's scheme liability theory is contrary to the language of Section 10(b), decades of precedent and sound public policy. It is nothing but an attempt to revive aiding and abetting liability under a different name. The Court should affirm the decision of the Eighth Circuit and reject Petitioner's attempt to rewrite the securities laws.

ARGUMENT

I. PETITIONER'S PROPOSED "PURPOSE AND EFFECT" STANDARD FOR IMPOSING SCHEME LIABILITY IGNORES THE CLEAR LANGUAGE OF SECTION 10(b) AND WOULD CONSTITUTE A DRAMATIC DEPARTURE FROM ESTABLISHED PRECEDENT

A. Any Claim Asserted Under Section 10(b) Or Rule 10b-5 Must Satisfy The "Use Or Employ" And "In Connection With" Requirements

Section 10(b) of the Exchange Act makes it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o *use or employ, in connection with the purchase or sale of any security*, . . . any manipulative or deceptive device or contrivance. . . ." 15 U.S.C. § 78j (2007) (emphasis added). These "use or employ" and "in connection with" requirements apply to any Section 10(b) claim, whether or not it alleges scheme liability under Rule 10b-5(a) and (c).[2]

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[2] *See, e.g., Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994) ("[A] private plaintiff may not bring a [Rule] 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)."); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (same); *United States v. O'Hagan*, 521 U.S. 642, 651 (1997) ("Liability under Rule 10b-5 . . . does not extend beyond conduct

(Continued on following page)

Additionally, *Central Bank* makes clear that a plaintiff can hold a defendant liable as a primary violator only if the conduct of *that* defendant satisfies "all of the requirements" of Section 10(b). 511 U.S. at 191. A plaintiff cannot "borrow" an element of Section 10(b) liability from one defendant and apply it to another defendant. Accordingly, to maintain a claim against multiple defendants, a plaintiff must show that *each* defendant acted "in connection with the purchase or sale" of a security and that *each* defendant "used or employed" a deceptive device in so doing.

While Petitioner and its *amici* claim to base their argument on the plain language of Section 10(b), they fail to consider these important statutory elements. Instead, they ask the Court to interpret the word "deceptive" in a vacuum. Petitioner's interpretation of "deceptive" contradicts the clear statutory language of Section 10(b) when the word is considered in context.

B. The "In Connection With" Requirement Is Satisfied Only If A Defendant's Fraudulent Actions Necessarily Required Or Depended Upon A Securities Transaction

To satisfy the "in connection with" requirement, a defendant's conduct must "touch" upon or "coincide" with a securities transaction. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971) ("The crux of the present case is that [plaintiff] suffered an injury as a result of deceptive practices touching its sale of securities as an investor."); *Zandford*, 535 U.S. at 820 ("[R]espondent's fraud coincided with the [securities] sales. . . .").

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encompassed by § 10(b)'s prohibition."); *S.E.C. v. Zandford*, 535 U.S. 813, 816 n.1 (2002) (same).

This Court's precedent demonstrates that the terms "touch" and "coincide," and the concept of dependence, are not trivial or *de minimis* standards reaching any conduct that happens to have some impact on the securities markets. *See Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 38 (1977) (phrase "in connection with the purchase or sale of securities" is "limiting language"). To the contrary, a defendant's conduct "touches" or "coincides" with a securities transaction only if completion of the defendant's alleged fraudulent act *necessarily required or depended upon* a securities transaction. *See, e.g., O'Hagan*, 521 U.S. at 656 (defendant's fraud "consummated" by his securities trades; fraud would not have existed without the improper securities transactions – "in connection with" satisfied); *Zandford*, 535 U.S. at 820-21 (emphasizing that securities sales and defendant's fraudulent acts "were not independent events" because "each sale was made to further [his] fraudulent scheme," a scheme that "*coincided* with" and "*require[d]* the sale of securities" – "in connection with" satisfied) (emphasis added); *id.* at 820 (distinguishing hypothetical case where fraud would be complete – *either* – before *or* after – securities transaction occurred – "in connection with" not satisfied); *Bankers Life*, 404 U.S. at 8 (fraudulent scheme to purchase securities of corporation using that corporation's own assets *depended upon* sale of its securities – "in connection with" satisfied); *The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 590-92 (2001) (plan not to allow exercise of stock option sold to plaintiff *necessarily required* sale of that option – "in connection with" satisfied).

An analysis of this Court's decisions applying the "in connection with" requirement shows that the requirement is satisfied only when a defendant's fraudulent activities require or depend upon a securities transaction. In each case, the "in connection with" requirement was satisfied

only if the defendant engaged in at least one of the following acts: (i) making a misrepresentation or false disclosure to *investors*; (ii) breaching a fiduciary duty owed to plaintiffs; and/or (iii) engaging in insider trading.

Case	Description	Misrepresentation to Investors?	Breach of Fiduciary Duty Owed to Plaintiffs?	Insider Trading?
Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 8 n.1 (1971)	Controlling stockholder misrepresented to investor that proceeds of a securities sale would be exchanged for certificate of deposit of equal value, thus breaching its fiduciary duty to corporation	✓	✓	
The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588, 596 (2001)	Corporation's promise to sell stock option while secretly intending not to permit its exercise constituted misrepresentation to investor	✓		

Case	Description	Misrepresentation to Investors?	Breach of Fiduciary Duty Owed to Plaintiffs?	Insider Trading?
S.E.C. v. Zandford, 535 U.S. 813, 823 (2002)	Broker breached fiduciary duty owed to his clients		✓	
Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972)	Market makers breached fiduciary duty owed to securities sellers		✓	
United States v. O'Hagan, 521 U.S. 642, 647 (1997)	Defendant bought call options based on material, non-public information			✓

The conduct alleged in each and every case in which this Court has found the "in connection with" requirement to be satisfied is conspicuously absent here. Petitioner here alleges merely that Respondents agreed to sell set-top boxes to Charter at inflated prices, to purchase advertising from Charter using the money it received from the inflated prices and to create new, backdated documents to reflect this agreement. Completion of these transactions by Respondents *in no way* required or depended upon any purchase or sale of Charter securities. In addition, as Petitioner concedes, Respondents made no misrepresentations to anyone, let alone to Charter shareholders. Respondents owed no fiduciary duty to Charter investors and did not trade in Charter securities. Consequently, Petitioner's allegations about Respondents do not involve either the type of conduct

or the relationship to the securities markets necessary to fulfill the "in connection with" requirement of Section 10(b). Respondents therefore cannot be liable for a violation of Rule 10b-5.[3]

C. A Defendant "Uses" Or "Employs" A Deceptive Device Only If It Directs A Specific And Affirmative Deceptive Act Toward Investors

This Court has not explicitly construed the terms "use" or "employ" in the context of a Section 10(b) claim. These words are straightforward and should be given their plain meaning. Both "use" and "employ" are active verbs. As such, they require some positive action. *See McGann v. Ernst & Young,* 102 F.3d 390, 394 (9th Cir. 1996) (holding that "the words 'use' and 'employ' require some positive action").[4] Congress' inclusion of this dynamic language demonstrates that Section 10(b) requires a defendant to engage in an affirmative act in order to be held liable. Moreover, the full text of the statute demonstrates that not any affirmative act will do. Instead, Section 10(b) requires a defendant to "use" or "employ" a "deceptive device" "in connection with the purchase or sale of securities."

In order to use or employ a deceptive device within the meaning of Section 10(b), a defendant must take an

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[3] The NAM takes no position as to the propriety of Respondents' conduct other than to state that the alleged conduct does not give rise to a private claim for damages under Section 10(b).

[4] "Use" and "employ" had very similar and inter-referential dictionary definitions when Section 10(b) was enacted. Webster's New International Dictionary (2d ed. 1934) defined "use" *inter alia* as "[t]o convert to one's service; to avail oneself of; to employ. . . ." and "[t]o put into operation; to cause to function. . . ." *Id.* at 2806. It defined "employ" *inter alia* as "to make use of, as an instrument, means or material; to apply; use. . . ." *Id.* at 839.

affirmative action and that action itself must deceive someone. Merely participating in *creating* a deceptive device does not satisfy the "use or employ" requirement. That requirement is only satisfied by a party that uses or employs the device to deceive investors. The act of creating or facilitating a deceptive device constitutes, at most, aiding and abetting another person's primary Section 10(b) violation. *See* Andrew S. Gold, *Reassessing the Scope of Conduct Prohibited by Section 10(b) and the Elements of Rule 10b-5: Reflections on Securities Fraud and Secondary Actors*, 53 Cath. U. L. Rev. 667, 680-83 (Spring 2004) ("Whatever degree of participation is demonstrated, if someone else's statements do the deceiving, the participant still cannot be said to 'use' the device to deceive.").[5]

Therefore, Charter's alleged reporting of inflated earnings to its investors based on its accounting for its transactions with Respondents constitutes a primary violation of Section 10(b). In order to deceive its investors, Charter allegedly conspired with Respondents to create inflated and backdated contracts. However, Respondents themselves are not alleged to have used or employed these

[5] Holding that Section 10(b)'s utilization of the term "use or employ" requires direct interaction with investors would be consistent with the manner in which this Court has interpreted those terms in construing other statutes. *See, e.g., Bailey v. United States*, 516 U.S. 137, 143 (1995) (federal statute imposing penalties for "use" of firearm during or in relation to drug trafficking offense required "*active employment*" of that firearm by defendant); *United States v. Cyprian*, 197 F.3d 736, 739 (5th Cir. 1999) (noting that various dictionary definitions of "use" suggest "action and implementation"); *Jones v. United States*, 529 U.S. 848, 855 (2000) (federal statute prohibiting destruction by fire or explosives of any building "used" in an activity affecting interstate or foreign commerce required more than a mere "passive, passing, or past connection to commerce").

backdated contracts to deceive anyone.[6] At most, Petitioner alleges that Respondents facilitated the creation of a deceptive device (*i.e.*, the contracts) that *Charter* thereafter used and employed to deceive investors.[7] Such conduct, if established, could amount to nothing more than aiding and abetting Charter's violation of Section 10(b), and thus could not give rise to primary liability in a private lawsuit brought under Section 10(b). *Central Bank*, 511 U.S. at 191. This distinction between primary and secondary violators is critical to manufacturers, who have no control over their purchasers' conduct, how their purchasers will account for transactions, how they will use documents associated with those transactions or whether or how they will make disclosures to their shareholders about any such transactions.

D. Petitioner Ignores Section 10(b)'s "Use Or Employ" And "In Connection With" Requirements, As Does Petitioner's Proposed "Purpose And Effect" Test

Petitioner pays scant attention to the "in connection with" and "use or employ" requirements. In quoting the statute, Petitioner conveniently omits any mention of the

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[6] Respondents are not even alleged to have created the purported scheme; Petitioner alleges that *Charter* devised the scheme and sought participants in it. *See* Pet. Br. at 5-6.

[7] Petitioner does not suggest that Respondents misled Charter in any way. This case is similar to most scheme liability cases, where plaintiffs typically allege that the third party vendor conspired with the issuer, rather than misleading it. *See, e.g., Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (2006); *see also Dutton v. D & K Healthcare Res.*, No. 4:04CV147SNL, 2006 WL 1778863 (E.D. Mo. June 23, 2006). Moreover, as discussed above, even an allegation that Respondents misled Charter would not be actionable under the securities laws because it would fail to satisfy the "in connection with" requirement.

"use or employ" or "in connection with" language, stating only that "Section 10(b) prohibits 'any . . . deceptive device or contrivance' by 'any person, directly or indirectly.'" Pet. Br. at 18. Petitioner limits its discussion of the "use or employ" requirement to one sentence in a footnote, suggesting only that "employ" is a synonym for "use" and that neither word requires any particular relationship between the defendant and those injured by the conduct. *Id.* at 20 n.6. Petitioner's treatment of the "in connection with" requirement is similarly negligible and conclusory. *Id.* at 22 (asserting with little explanation that "[t]he 'in connection with' language is more than satisfied here"). Petitioner's *amici* do not fare any better. With the exception of quoting the text of Section 10(b), none of them mention the "use or employ" or "in connection with" requirements at all.

Instead, Petitioner urges the Court to adopt a test that would hold third parties liable where "the purpose and effect of [their] conduct [was] to create a false appearance of material fact in furtherance of [a] scheme" to defraud the issuer's shareholders. Pet. Br. at 32. Petitioner's proposed test for scheme liability contradicts the clear language of Section 10(b) and the prior holdings of this Court.

First, the "purpose and effect" test ignores the "in connection with" and "use or employ" requirements entirely. Indeed, Petitioner's test would be met any time a common law fraud related in any way to securities. This approach directly contradicts this Court's warning that "the statute must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of § 10(b). . . ." *Zandford*, 535 U.S. at 820; *see also Chiarella v. United States*, 445 U.S. 222, 232 (1980) ("[N]ot every instance of financial

unfairness constitutes fraudulent activity under § 10(b)."). Thus, Petitioner's reading of the statute unduly expands the scope of Section 10(b), despite the fact that "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

In addition, Petitioner's "purpose and effect" test directly contradicts the Court's holding in *Central Bank*. Imposing liability on those whose conduct had "the purpose and effect of . . . creat[ing] a false appearance of material fact in furtherance of [a] scheme" would allow plaintiffs to evade *Central Bank*'s abolition of private actions for aiding and abetting liability. Before *Central Bank*, plaintiffs routinely labeled as "aiding and abetting" the kind of conduct that Petitioner now claims satisfies its "purpose and effect" test. *See, e.g., Feldman v. Pioneer Petroleum, Inc.*, 813 F.2d 296, 301 (10th Cir. 1987) (bank "aided and abetted in a conspiracy to promote the scheme by engaging in a fraudulent and deceptive transaction to create the false appearance to prospective investors" that a company would obtain loans from the bank).

Approval of Petitioner's "purpose and effect" test would revive aiding and abetting liability under a different name. Over the past few decades, this Court and the Congress have repeatedly attempted to curtail frivolous securities fraud litigation. Creative plaintiffs have attempted to circumvent these rulings, necessitating repeated clarifications from this Court. Petitioner is merely the latest in a long line of litigants that have sought to find ways around this Court's ruling in *Central Bank*. The NAM respectfully suggests that this Court not permit Petitioner to undermine the carefully developed jurisprudence in this area.

E. Section 10(b) Liability Requires A Breach Of A Duty To Plaintiffs

As the court below correctly stated, "[a] device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) (citing *Santa Fe Indus. v. Green,* 430 U.S. 462, 474-75 (1977)). The Eighth Circuit's holding that duty (either created by speaking to investors or as a result of a fiduciary relationship) is a prerequisite to Section 10(b) liability provides a bright line rule that is consistent with this Court's precedent.

In *Affiliated Ute*, the Court considered the failure of market makers to disclose material information with respect to certain stock sales. The Court paid particular attention to the duty that the market makers owed the plaintiff under Rule 10b-5. Had the defendants acted merely as transfer agents, the Court explained, there would have been no duty to disclose. Instead, the defendants actively encouraged a market for the securities, and therefore were liable under Section 10(b) because of their "affirmative duty" to disclose information to investors. *Affiliated Ute*, 406 U.S. at 152.

The Court reaffirmed the importance of duty in *Chiarella*, where it held that an employee of a financial printer who bought stock after discovering the identity of the target in a corporate takeover bid could not be liable under Rule 10b-5(a) and (c) because he owed no disclosure duty to the shareholders of that target corporation. *Chiarella*, 445 U.S. at 228. As the Court held, omissions are actionable only where there is a duty to disclose based on a specific relationship between two parties. "The element required to make silence fraudulent – a duty to disclose – is absent in this case. No duty could arise from

petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them." *Id.* at 232.

The Court continued to emphasize duty in subsequent Section 10(b) cases. *See, e.g.*, *Dirks v. S.E.C.*, 463 U.S. 646, 666-67 (1983) (holding that, in absence of a breach of a fiduciary duty to shareholders by insiders who provided defendant with inside information, there was no derivative breach by the defendant and thus no liability); *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5."); *O'Hagan*, 521 U.S. at 662 (reiterating that Section 10(b) liability "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction") (quoting *Chiarella*, 445 U.S. at 230).

In sum, this Court has employed the bright line "duty" standard for Section 10(b) liability for the past several decades. This standard has provided manufacturers and vendors of products who engage in commercial transactions with public companies with a clear standard on which they could rely in shaping their conduct. Manufacturers and vendors understand that under existing precedent, because they owe no duty to the shareholders of those companies with which they do business, they have no obligation to make any disclosures to those shareholders. In the absence of any material statements made by a manufacturer to its purchasers' shareholders, a manufacturer has no possible civil liability under the securities laws to those shareholders. The "purpose and effect" test advocated by Petitioner diverges dramatically from these clear legal principles. The NAM respectfully suggests that the Court should reject this standard because it deviates from the statutory language and ignores decades of precedent.

II. PETITIONER'S PROPOSED "PURPOSE AND EFFECT" TEST IS CONTRARY TO SOUND PUBLIC POLICY

A. The Uncertainty Generated By Petitioner's "Purpose And Effect" Test Would Chill Legitimate Commerce And Harm The Economy As A Whole

As it has in the past, this Court should consider the policy implications of changing the scope of private civil liability under Section 10(b) and Rule 10b-5. *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975) (explicitly basing decision to limit standing under Section 10(b) and Rule 10b-5 to purchasers and sellers partly on policy considerations); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510-11 (2006).

Such policy considerations include certainty and predictability, oft-recognized and laudable goals of statutory interpretation. *See, e.g., McBoyle v. United States*, 283 U.S. 25, 27 (1931) ("[F]air warning should be given to the world in language that the common world will understand, of what the law intends to do if a certain line is passed. To make the warning fair, so far as possible the line should be clear."); *Wilson v. Garcia*, 471 U.S. 261, 275 (1985) (stating that the Court's interpretation of a statute was supported by federal interests in uniformity, certainty and the minimization of unnecessary litigation).

Indeed, this Court relied on exactly such policy considerations in eliminating the private right of action for aiding and abetting liability. In *Central Bank*, this Court noted that "[t]he rules for obtaining aiding and abetting liability [were] unclear, in [securities litigation,] 'an area that demands certainty and predictability.'" *Central Bank*, 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). Lack of clarity "leads to the undesirable result of

decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business." *Id.* The Court concluded: "'[S]uch a shifting and highly fact oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5' is *not* a 'satisfactory basis for a rule of liability imposed on the conduct of business transactions.'" *Id.* (quoting *Blue Chip Stamps*, 421 U.S. at 755) (emphasis added).

The Eighth Circuit's test, *supra* at 15, promotes certainty and predictability by informing companies that they can be held liable as primary Section 10(b) violators to the shareholders of another company only if they make a disclosure to those shareholders or otherwise owe them a duty. In contrast, under Petitioner's test, a company doing business with an issuer would be liable if the "purpose and effect" of the conduct at issue was found to create a false appearance of material fact in furtherance of a scheme to defraud the issuer's shareholders. That test provides neither certainty nor predictability. Were the Court to abandon decades of precedent and adopt Petitioner's proposed standard, a manufacturer would not know when an issuer's shareholder might allege that the issuer misrepresented details about a transaction with the manufacturer. Such a standard would offer manufacturers virtually no guidance, let alone certainty, regarding their potential liability.

Moreover, adoption of Petitioner's proposed standard would lead to an explosion of new scheme liability cases against manufacturers and other third parties. Despite the fact that this Court has never given any credence to Petitioner's scheme liability theory, there has been a recent proliferation of scheme liability cases, as creative plaintiffs have attempted to circumvent this Court's holding in *Central Bank*. The facts that plaintiffs consider

sufficient to give rise to securities fraud liability in these cases demonstrate the risks inherent in throwing open the floodgates of scheme liability by adopting Petitioner's proposed standard.

For example, vendors of goods and services have been sued under Rule 10b-5 "scheme" liability for (i) providing rebates on volume purchases of products because the purchaser allegedly failed adequately to describe the rebate program and its potential effect on the purchaser's business, *Amalgamated Bank v. Dell, Inc.*, Civ. Action No. 1:07-CA-00077-LY (W.D. Tex. Jan. 31, 2007); (ii) providing goods or services to a purchaser because the purchaser allegedly misrepresented the transaction and inflated its assets, *Dutton*, 2006 WL 1778863; and (iii) entering into commercial transactions because the other party allegedly recognized revenue improperly in connection with those transactions, *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003).[8] If this Court were to adopt Petitioner's amorphous "purpose and effect" test, the type of commercial entities that would be ensnared into the "scheme" web would be limited only by plaintiffs' counsel's imagination.[9]

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[8] Financial services firms also have faced scheme liability suits for setting up and/or financing transactions that an issuer allegedly misrepresented in its financial statements. *See, e.g.*, *In re Enron Corp.*, No. MDL-1446, Civ. Action No. H-01-3624, 2006 WL 4381143 (S.D. Tex. June 5, 2006); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005); *Quaak v. Dexia*, 357 F. Supp. 2d 330 (D. Mass. 2005); *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804 (S.D. Tex. 2004); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161 (D. Mass. 2003).

[9] Petitioner suggests that its proposed test will not create unfairness or uncertainty because companies either are "good" (and therefore not at risk of liability) or "bad" (and therefore not worthy of protection). *See* Pet. Br. at 32-34. The idea that "good" companies have nothing to worry about ignores practical reality. There is no reason to believe a plaintiff will know (or act upon) the "truth" about a defendant

(Continued on following page)

Although the alleged facts of these recent scheme cases vary slightly, they all have one thing in common. In each, the third party had no contact with the issuer's shareholders, and it was the issuer that made an alleged misrepresentation to its shareholders. As importantly, the third party lacked any control over how the issuer reported its dealings with the third party to its shareholders. By linking a third party's liability to the issuer's actions, Petitioner's test requires the third party to assume the risk that the primary violator will do something inappropriate over which the third party has no control.

The lack of certainty and predictability generated by the "purpose and effect" test would have a chilling effect on legitimate commerce and a negative effect on the economy as a whole. It would ask manufacturers to assume the costly and impossible role of watchdog over the conduct of their customers to ensure that they properly account for and disclose any transactions with that manufacturer. For example, in order to limit their Section 10(b) liability:

- Manufacturers would be forced to analyze their public customers' disclosures and financial statements to determine whether those customers correctly reported and accounted for transactions with the manufacturer;
- Manufacturers would be incentivized to do business with foreign or private companies rather than public U.S. companies to avoid risking securities fraud liability;

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ex ante and will only allege securities fraud against "bad" companies. Plaintiffs and their counsel are not triers of fact and cannot be counted on to serve a gatekeeper function.

- Manufacturers would hesitate to modify existing contracts at their customers' request for fear that the modifications, if undisclosed to their customers' auditors, would allow manipulation of their customers' financial results;
- Manufacturers would balk at including legitimate and competitively reasonable confidentiality provisions in their agreements, fearing plaintiffs would later claim those provisions reflect a scheme to conceal material information from the customers' investors;
- Manufacturers would think twice before advancing funds (*e.g.*, seller financing) or offering discounts to their customers out of concern that the customers would improperly account for the cash they received; and
- Manufacturers would be wary of doing business with public companies with high stock price volatility (*e.g.*, technology companies) because such companies could face greater potential securities fraud liability.

In sum, manufacturers would be forced to analyze business deals not only on their commercial merits but also on their potential for crushing securities fraud liability based on the conduct of a counterparty. That analysis would have to be done for each of the millions of sale transactions that take place annually. Adopting such a legal standard would harm manufacturers, their customers, the American consumer, and the U.S. economy as a whole.

Additionally, the significant litigation costs and possible broad liability imposed by the "purpose and effect" test would increase manufacturers' cost of production, causing them to pass these costs on to their customers. These price increases would undermine manufacturers'

competitiveness *vis-à-vis* foreign companies that do not face such costs or the risk of such massive liability. *See, e.g.*, Statement of J. Carter Beese, Jr., Chairman on behalf of the Capital Markets Regulatory Reform Project, Center for Strategic and International Studies before the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, 1995 WL 83860 (March 2, 1995) ("[F]rom my vantage point on the [Securities Exchange] Commission, I became concerned that the costs of regulation, and the costs of litigation, were placing an unnecessary drag on the competitiveness of U.S. companies and U.S. capital markets, and imposing needless costs on consumers."). By imposing this burden on manufacturers, scheme theories such as the "purpose and effect" test ignore the practical realities of conducting business. Changing the scope of Section 10(b) in such a drastic manner is the sole province of Congress, not the courts.

B. Petitioner's "Purpose And Effect" Test Would Encourage Frivolous Claims, Increase Defendants' Cost Of Litigating And Encourage Coercive Settlements

If Petitioner's "purpose and effect" test were adopted, plaintiffs would be able to allege scheme liability – and survive Section 12(b)(6) motions to dismiss – with relative ease. The lower courts that have permitted scheme liability formulations similar to Petitioner's proposed standard have done just that, permitting claims against parties that did not speak to investors and owed them no duty. *See, e.g., In re Lernout & Hauspie*, 236 F. Supp. 2d at 177 (defendants, including investment fund and insurance company, owing no duty to issuer's shareholders, allegedly set up and funded outside sham entities that did business with issuer – motions to dismiss denied); *In re Parmalat*,

376 F. Supp. 2d at 517 (defendant bank, owing no duty to issuer's shareholders, allegedly structured loans to issuer and established invoice securitization program – motion to dismiss denied in part); *Quaak*, 357 F. Supp. 2d at 342 (defendant bank, owing no duty to issuer's shareholders, allegedly structured loans to issuer – motion to dismiss denied); *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 378 (5th Cir. 2007) ("*Enron*") (investment banks, owing no duty to issuer's shareholders, allegedly structured transactions with issuer – motions to dismiss denied).

Adopting Petitioner's standard would make it difficult for manufacturers, vendors and service providers who made no misrepresentations to plaintiffs, and who had no duty to them, to extricate themselves from frivolous lawsuits at an early stage.[10] Indeed, Petitioner's vague test would allow a plaintiff to survive a motion to dismiss just by uttering the talismanic phrases, "scheme to defraud" and "purpose and effect."

Petitioner's test is easy to allege and hard to refute on a motion to dismiss. Consider, as a hypothetical, that Supplier sells component parts for a finished product to Manufacturer (a public company) with the understanding that the parts can be returned by Manufacturer for any reason within 60 days. Supplier includes the right of return provision in a separate letter agreement, rather than the purchase order. Manufacturer records the purchase correctly in its financial statements. Supplier, however, incorrectly records excess revenue from the sale by claiming it is non-contingent and final and showing the

[10] In addition, more manufacturers will be sued if plaintiffs can ignore the limits of Section 10(b) (*e.g.*, the "in connection with" requirement) by alleging scheme liability.

purchase agreement, but not the side letter agreement, to its auditors. When the true nature of the transaction comes to light, Supplier's stock price falls and it files for bankruptcy. Supplier's shareholders then sue *Manufacturer* for securities fraud, alleging that Supplier and Manufacturer conspired to defraud them and that the "purpose and effect" of the separate side letter was to create a false appearance of material fact in order to further the scheme. In this example, Petitioner's "purpose and effect" test would sweep a third party actor into costly litigation merely because it engaged in a legitimate transaction with an issuer that may not have disclosed the transactions appropriately.

Additionally, the heavy cost of being mired in meritless, intractable litigation would encourage non-issuer defendants to enter into coercive settlements. *See, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007) ("Private securities fraud actions . . . , if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law."); *Blue Chip Stamps*, 421 U.S. at 740 ("[E]ven a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.").

Moreover, secondary actors often must expend large amounts of money, even on pretrial matters. *See* 138 Cong. Rec. S12605 (Aug. 12, 1992) (remarks of Sen. Sanford) (asserting that in many securities fraud cases, major accounting firms pay eight dollars in legal fees for every one dollar paid in claims). The General Counsel of Sun Microsystems, for instance, testified before Congress as to

the effects of two frivolous securities fraud lawsuits that had been filed against Sun:

> [We] litigated these two matters vigorously, spending over $2.5 million on attorney fees and expenses in the period from June 1989 through January 1993; our directors and officers liability carrier spent approximately $2 million more. These figures do not include the public relations costs, many hours of senior management time diverted to the litigation, and the uncertainty generated by the situation. . . . [O]ur Board regarded it as a matter of fiduciary duty to explore settlement seriously, even though the idea of settling was deeply offensive to us. But the grim prospect of a jury trial, with all of its inherent unpredictability, forced us to consider any kind of "reasonable" settlement that might be achieved. Accordingly, [we] agreed to settle the first matter for $25 million, half of which was paid by the insurance carrier; and the second matter for $5 million, half of which also was paid by insurance. Of course, one-third of these settlements went to plaintiffs' counsel, not to any shareholder.

Testimony of Michael Morris, Vice President and General Counsel of Sun Microsystems before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, 1998 WL 96483 (F.D.C.H.) (Feb. 23, 1998). Scheme liability cases would serve to increase those litigation costs, and coerced settlements, unnecessarily.

The risk of coercive settlements is heightened for a third party that may have had limited involvement with an issuer but who potentially faces joint and several liability for all of the issuer's acts – acts over which it had no control. *See* 15 U.S.C. § 78u-4(f)(2)(A) (2007). Given the large market capitalizations of many companies in the United States and the correspondingly large declines in

value following the announcement of disappointing news, adoption of Petitioner's proposed standard would create the prospect that numerous manufacturers and other third parties would face *billions* of dollars in potential joint and several liability simply because they have done business with a company that is accused of securities fraud. The *in terrorem* effect of joint and several liability further underscores the likely chilling effect of broad scheme liability on domestic commerce.

This Court has long understood that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739. Over the years, both Congress and this Court have taken steps to mitigate this danger. In *Blue Chip Stamps*, for example, the Court limited standing in private Rule 10b-5 actions to purchasers and sellers of securities, citing the need for a bright-line rule. *See id.* at 742. In *Central Bank*, the Court dispensed with aiding and abetting liability in private actions partly because it "exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets." *Central Bank*, 511 U.S. at 188. More recently, in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346 (2005), the Court determined that plaintiffs must make a meaningful showing of actual loss causation in order to maintain a private right of action under Section 10(b). Then, only a few weeks ago, the Court again raised the bar for plaintiffs by elevating the scienter pleading standards in many circuit courts. *Tellabs, Inc.*, 127 S. Ct. at 2504-05.

Indeed, the *Central Bank* Court acknowledged the very same kinds of costs that the NAM has pointed out here. "[U]ncertainty and excessive litigation can have ripple effects. . . . [N]ewer and smaller companies may find it difficult to obtain advice from professionals. A professional

may fear that a newer or smaller company may not survive and that business failure would generate securities litigation *against the professional*, among others. In addition, the increased costs incurred by professionals because of the *litigation and settlement costs under 10b-5 may be passed on* to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute." 511 U.S. at 189 (emphasis added). Similarly, the uncertainties associated with Petitioner's scheme theory reduce the willingness of companies to do business with one another, and the massive litigation and settlement costs generated by Petitioner's theory ultimately get passed to consumers.

For its part, Congress enacted the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), Pub. L. 104-69, 109 Stat. 737 (Dec. 22, 1995) to curb these costs and abuses, including "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and 'manipulation by class action lawyers of the clients whom they purportedly represent'. . . ." *Dabit*, 126 S. Ct. at 1510-11 (quoting H.R. Rep. No. 104-369, p. 31 (1995)). In addition to imposing stringent pleading requirements, *see* 15 U.S.C. § 78u-4(b) (2007), the PSLRA reflected Congress' tacit approval of *Central Bank*'s bar on private aiding and abetting liability. *Cf.* 15 U.S.C. § 78t(e) (2007) (allowing SEC enforcement against aiders and abettors but not creating a private right of action). Moreover, when it became apparent that plaintiffs were attempting to avoid the PSLRA's strictures by bringing securities fraud class actions in *state* court, Congress enacted the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. 105-353, 112 Stat. 3227 (Nov. 3, 1998). *See Dabit*, 126 S. Ct. at 1511 (broadly construing SLUSA's pre-emption provisions to better effect the PSLRA's goals).

To permit scheme liability would not only allow Petitioner to circumvent *Central Bank*'s clear prohibition on private aiding and abetting liability, but also would undermine more than 30 years of carefully-crafted judicial and congressional efforts to cabin frivolous securities fraud litigation.

C. Section 10(b) Jurisprudence Should Not Be Premised Upon A Search For Deep Pockets

Petitioner's *amici* suggest that, because issuers that engage in wrongdoing often are insolvent, outside actors are the only potential defendants "with assets sufficient to satisfy a judgment or fund a settlement. . . ." *See, e.g.*, AARP Br. at 3. According to these *amici*, investors require scheme liability to obtain adequate compensation. This argument rests upon the explicit premise that, whatever countervailing policy considerations might exist, "[n]one of them is more important . . . than the ability of defrauded investors to recover their losses. . . ." *Id.* at 12. That premise should be rejected.

Defrauded investors deserve redress, but their remedies should not come at the expense of those who did not violate the securities laws. Fairness – not a blind quest for compensation – is the most important consideration, and it is fundamentally unfair to craft Section 10(b) jurisprudence around an indiscriminate search for deep pockets. *See Dura Pharmaceuticals*, 544 U.S. at 345 (stating that it is *not* the goal of the securities laws "to provide investors with broad insurance against market losses"). It also is fundamentally unfair to impose massive defense costs and liability on third parties simply because they did business with a primary violator. Guilt by association is not a reasonable or fair way to define the scope of Section 10(b).

Indeed, if the Court adopts Petitioner's proposed "purpose and effect" test, it would permit issuers and their officers and directors (*i.e.*, those alleged to have actually made misleading statements to shareholders) to seek contribution from manufacturers and other companies that did business with them. Were this to occur, securities litigations would become even more complex and expensive than they already are. Moreover, such third party practice would tend to shift liability from the parties who ordinarily are most central to any alleged fraud to those with only a tangential relationship to the alleged fraud simply because they have deeper pockets. Revising the scope of Section 10(b) to compensate investors from the coffers of any company that may have aided and abetted a primary violation, as Petitioner and its *amici* advocate, requires an act of Congress, not an expansion of an implied right of action by the courts. *See In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d at 993 (a "decision[] of this magnitude should be made by Congress[,]" if at all).

IV. CONCLUSION

For the reasons stated above, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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